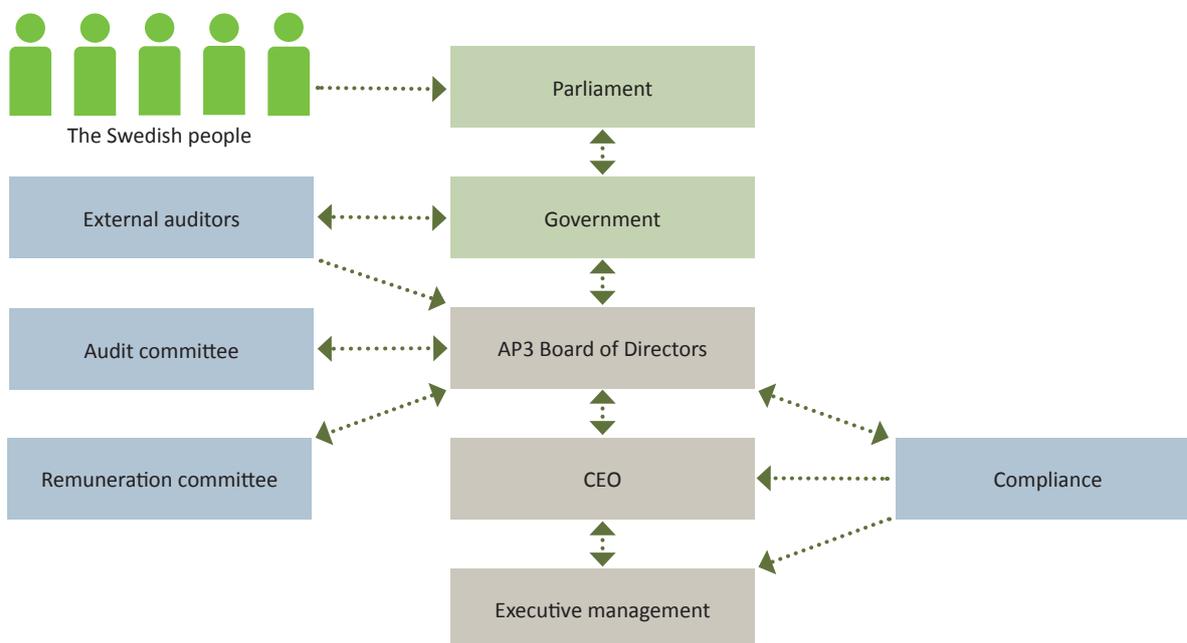


## GOVERNANCE REPORT 2011

### Administration



Along with the other AP funds, AP3 is a state-owned pension fund. The AP funds differ from other state-owned institutions in their independence from the government. This is because the funds' operations are prescribed by statute and the government has waived its regulatory powers.

This governance report was prepared in conformity with the Financial Statements Act and relevant provisions of the Swedish corporate governance code.

#### Important external and internal requirements that regulate governance at AP3.

- National Pension Funds Act
- Financial Statements Act
- Book-keeping Act
- Administrative Procedure Act
- Freedom of information
- Public Procurement Act
- Swedish corporate governance code
- Government policy on governance and evaluation of the AP funds
- Accounting and valuation policies of the AP funds
- AP3's governance framework

#### Board of Directors

The AP3 Board has nine members, all appointed by the government. Two directors are appointed from nominees of employee organisations and a further two from nominees of employer organisations. The government appoints the Chairman and Deputy Chairman from its own nominees.

The government stipulates a maximum eight-year term for directors in its Policy for Governance and Evaluation of the AP Funds. Reflecting this policy, the government in 2011 appointed Pär Nuder as Chairman to succeed Claes de Neergaard. Deputy Chairman Lars G Josefsson did not stand for reelection and was replaced by Björn Börjesson. Government policy is for directors to serve one-year terms. Hence, current board memberships extend until approval of the 2011 balance sheet and income statement.

### Board administration

The National Pension Funds Act gives the Board of Directors full and collective responsibility for AP3's operations and administration, within the parameters set by Parliament. Board responsibilities and activities not prescribed by statute are set out in the Board's work plan, which is approved annually by the directors.

The National Pension Funds Act also requires the Board to approve an annual operating plan. The operating plan must contain guidelines for investing activities and for exercising AP3's voting rights at the entities in which it invests. It must also contain a risk management plan. Beyond this, the Board sees its primary tasks as setting operating targets, recruiting and monitoring the performance of the CEO, managing strategic documents and making decisions on general Fund strategy (including overall risk levels and deviation and risk mandates). The directors apply the Fund's dynamic asset allocation model and discuss allocations to the different risk categories and any changes at every Board meeting. Effective control and monitoring are necessary for ensuring that Board decisions are implemented, that risk management is effectual and that the Fund operates in an appropriate manner.

The Board has the task of approving the corporate governance policy and managing other overseeing the Fund's focus areas prior to each AGM season, while generally leaving day-to-day decisions and actions to the CEO.

The CEO and other AP3 employees also attend Board meetings as experts or in a reporting capacity. The Board annually reviews the CEO's administration. The CEO is not party to this process.

### Review of the Board's administration

The Board of Directors conducts an annual review of its own work. In 2011 this review was based on a standard questionnaire, with space for each director to make personal comments. The Board discussed the results of the review at its strategy meeting.

### Remuneration of directors

The government sets the fees and other remuneration payable to directors. Board fees are SEK 100,000 per year for the Chairman, SEK 75,000 for the Deputy Chairman and SEK 50,000 for other directors. These fees have remained unchanged since 2000. The government also has an annual fund of SEK 100,000 to remunerate directors for committee work and other assignments. In 2011 the Board used this fund to pay fees of SEK 26,520 to the chairman of the Audit Committee and SEK 21,220 to other Audit Committee members, and fees of SEK 10,300 to each Remuneration Committee member (including the chairman). (See Note 7, Employees, in the 2011 annual report)

### Board committees

The Board of Directors has two committees: the Remuneration Committee and the Audit Committee.

The Remuneration Committee has the task of ensuring that salaries and other remuneration are market-based, competitive, appropriate and reasonable. The committee reviews issues relating to the CEO's salary and other remuneration and oversees and monitors the implementation of government guidelines. It also conducts an annual review of AP3's performance-based remuneration system.

### Board administration in 2011

The Board of Directors held six scheduled meetings during the year and also met for an information meeting during the summer. One of the scheduled meetings was an extended session to discuss strategic issues.

	Board meeting attendance <sup>1</sup>	Remuneration Committee meetings	Audit Committee meetings <sup>2</sup>
Pär Nuder from June 2011	4/4	Chairman from June 2011 (2/2)	
Claes de Neergaard until May 2011	2/2	Chairman until May 2011 (2/2)	
Björn Börjeson from June 2011	3/4		
Lars G Josefsson until May 2011	1/2		
Sonat Burman-Olsson	5/6		Member (5/5)
Lars Ernsäter	6/6	Member (4/4)	
Kari Lotsberg	6/6		Chairman (5/5)
Ingela Gardner Sundström	6/6	Member (4/4)	
Gunvor Engström	6/6		
Inga-Lill Carlberg	5/6		
Peter Hellberg	5/6		Member from June 2011 (2/2)
Total			

1. The Board held two scheduled meetings prior to June and four scheduled meetings and an information meeting thereafter.

2. A vacancy in the Audit Committee was filled in June. Thereafter the committee held two meetings.

The Remuneration Committee reports directly to the Board and decisions are taken by the Board. Pär Nuder replaced Claes de Neergaard as Remuneration Committee chairman during the year. The other members were Lars Ernsäter and Ingela Gardner Sundström. The CEO is a co-opted member in all issues not relating to her personal remuneration. The Remuneration Committee held four meetings during the year.

The Audit Committee has an advisory and oversight role on behalf of the Board in matters relating to financial reporting and accounting, internal control, risk management and external audit. The committee reports to the Board. The Audit Committee held five meetings during the year and its members were Kari Lotsberg (chairman), Sonat Burman-Olsson and (as of June) Peter Hellberg. The Fund's auditors attended the meetings held to discuss the final audit and audit management.

### Significant issues arising from the Board's administration in 2011

In addition to its task of finalising the annual accounts, budget, operating plan and risk management plan, the Board's work in 2011 included:

#### ■ Allocation decisions

At each Board meeting the directors discuss the Fund's overall risk level as well as individual risk bands for each risk category. Decisions are based on macroeconomic analysis, valuations and investors' appetite for risk. The Board delegates to the CEO implementation and management of the portfolio within the allocated risk bands and the CEO reports back to the Board at its next meeting. In 2011 the Board decided to change the Fund's risk category allocation bands on two separate occasions.

During the year the Board also reviewed its guidance and mandates to the CEO in alternative investments and the Board's mandate to the CEO concerning illiquid investments of this type.

#### ■ The European debt crisis

The mounting debt crisis in southern Europe and growing concern on financial markets had a major impact on the Board's administration, especially in the final six months of the year. In late summer the Board held an extra meeting to apprise itself of events, and macroeconomic analysis and allocation issues gained an even higher focus than before. The CEO is entitled to delegate some or all of the Board's deviation mandates to enable faster adjustment of the investment portfolio, provided she has the Board's consent.

#### ■ Risk analysis

In 2011 AP3 conducted a thorough analysis of total risk. This analysis provides the framework for identifying and evaluating risk throughout the Fund's operations and aims to provide an overview of risk based on an order of precedence of AP3's risk reduction measures. The risk analysis is based on a self-evaluation performed by the organisation and covering operating risk, business risk and reputation risk. The Audit Committee and the Board managed the risk analysis process.

#### ■ Asset management costs

Cost-effectiveness in fund management is always high on the Board's agenda. Costs are also addressed in the government's review of the AP funds and in the official response to this review issued by the Parliamentary Committee on Finance. The Board evaluates costs on a quarterly basis and the Fund also participates in an annual external benchmarking study of costs among leading international pension funds.

#### Government review

In its review of the AP funds' investment performance up to and including 2010, the government said it believed the funds had understood the challenge posed by periodic market volatility and that the differences between the funds' different asset management models were basically positive. At the same time, it stressed the need for transparency. The review said AP3's investment returns in the last five-year period had been unsatisfactory. The government noted continued progress by AP1, AP2, AP3 and AP4 in developing their environmental and responsible investment guidelines, including defining core values. The review decided there was a lack of context to evaluate the overview by the AP funds' boards of directors of whether employee remuneration levels were within government guidelines. Finally, the review urged the AP funds to continue working proactively to reduce their asset management costs.

In consultation with its Pensions Group, the government in September signed a directive to review the regulatory framework for the AP funds. The objective of the review is to improve conditions for cost-effective management of the pension system's capital buffer. The review is scheduled for completion by 1 August 2012.

#### External auditors

AP3's auditors are appointed by the government. During the year the government undertook a new procurement process for audit services to the AP funds and awarded the mandate to Ernst & Young. Anna Peyron and Peter Strand are AP3's auditors. Their mandate is for three years and runs until approval of the 2013 income statement and balance sheet, with an option for a one-year extension. Ernst & Young also audit the accounts of the other AP funds and Anna Peyron coordinates the audit process between the funds.

#### Review of administration and accounts

The auditors' work includes reviewing the Fund's operating activities, administration, annual accounts and accounting records. They express an opinion on the accounting records and the administration based on their audit. Their mandate also includes verifying that AP3 follows the accounting and valuation policies agreed jointly by the AP funds and that the accounting records give a true and fair view of AP3's operating activities. The government issued the auditors with a new mandate, starting in 2011, to validate the funds' estimates of risk and return. In the past, this validation was part of the government's annual AP fund performance review.

The auditors report orally to the Board at least once a year and submit written reports on their audit of the annual accounts and administration. The auditors normally meet the Audit Committee twice a year. They are responsible for checking to ensure compliance with government regulations on employment terms and conditions for senior managers at the AP funds. The auditors also submit a verbal report to the Ministry of Finance once a year.

### Internal control

The Swedish National Pension Funds Act (2000:192) states that the Board of Directors is responsible for AP3's administration, organisation and overall activities. These responsibilities include ensuring effective internal control. AP3 has a governance framework that defines its risk management, governance and control system and structure. The Board sets out general policies and guidelines that are then operationalised through instructions issued by the CEO. All governance documents are revised under a fixed schedule.

One key document is the Risk Management Plan, which is approved annually by the Board and describes the division of responsibilities among AP3 staff and departments. The division of responsibilities is designed to support the internal control structure to ensure the autonomy of internal control from the rest of the organisation. This dualistic structure is reflected in access authorisation to AP3's systems.

The internal control function comprises the Risk control and Compliance departments. Risk control focuses on financial risk; Compliance handles operating risk and conformity with regulations. Risk control is in charge of defining, identifying, monitoring and controlling risks arising in asset management operations. It also identifies and reports any deviations from set limits. Limits apply at various levels to ensure that AP3 operates within statutory guidelines and the rules set by the Board and CEO. The Compliance department is in charge of making sure the Fund operates within applicable external guidelines and in conformity with internal policies, guidelines and directives. This includes ensuring that the organisation is aware of relevant rules and applies them throughout its operations. The Compliance department also coordinates AP3's annual review of operating risks and monitors implementation.

Analysis and control is based on a daily transparent internal reporting of positions, risk and financial results. Management reports monthly to the Board (and more frequently if required). Any infringement of limits or similar incidents are reported to the Audit Committee and Board of Directors. Significant incidents are to be reported to the Board as soon as they arise. AP3's Compliance Officer and the Head of Risk and Financial Control report directly to the Board if necessary.

### Internal audit

The Swedish National Pension Funds Act (2000:192) does not require the AP funds to have an internal audit department. Internal audit has the task of ensuring that controls are implemented. It also verifies and evaluates the effectiveness of internal control. The AP3 Board asks the Audit Committee to review annually the need for an internal audit and to lead this process if required.

In 2011 AP3 commissioned PriceWaterhouseCoopers to carry out an internal audit of the Fund's mandate delegation and limit-monitoring processes. The internal audit concluded that the processes were satisfactory and that guidelines and instructions were in place to support mandate delegation and limit-monitoring and how these tasks are allocated within the organisation.

### Legal limits

In 2011 AP3 exceeded two legal limits – the 5% rule for holdings of unlisted assets and the 10% rule for single holdings in individual listed entities.

The sharp fall in the value of listed assets in 2008 and the fact that unlisted assets did not lose value to the same extent resulted in AP3 exceeding the rule limiting holdings of unlisted assets to no more than 5% of fund capital. The ratio of unlisted assets has since remained at just over or just under the 5% threshold, depending on changes in listed and unlisted assets values. The ratio stood at 5.4% on 31 December 2011. No new investment commitments have been made since 2009.

In 2009 AP3 acquired a 17% holding in Arise Windpower AB, which was unlisted at the time. Arise Windpower issued new shares in 2010 as part of an IPO. AP3's post-flotation voting rights were 14.7% of the equity, which was higher than the statutory 10% maximum in any single listed entity. AP3 held 13.9% of the voting rights in Arise Windpower at 31 December 2011.

The statutory requirement is that any holdings which exceed the stated limits must be sold as soon as market conditions allow and without incurring a loss.